DEPARTMENT OF STATE REVENUE

04-20050173.LOF

Letter of Findings Number: 05-0173
Sales/Use Tax
For Tax Years 2000 & 2001

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I. Sales/Use Tax–Miscellaneous Items

Authority: IC 6-8.1-5-1(b); 45 IAC 15-5-3(b); IC 6-2.5-3-2; IC 6-2.5-3-1; *USAir, Inc. v. Indiana Department of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); IC 6-2.5-5-3(b); 45 IAC 2.2-5-10(k); 45 IAC 2.2-5-8(j); 45 IAC 2.2-5-16; 45 IAC 2.2-5-14; Information Bulletin #8; Information Bulletin #2; 45 IAC 2.2-4-2; IC 6-2.5-2-1

Taxpayer protests the proposed assessment of sales/use tax on various items.

II. Tax Administration–Negligence Penalty and Interest

Authority: IC 6-8.1-10-1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty and interest.

STATEMENT OF FACTS

Taxpayer manufactures electronic components for various industries. More facts will be provided below as needed.

I. Sales/Use Tax–Miscellaneous Items

DISCUSSION

Before examining the taxpayer's protest, it should be noted that the *taxpayer* bears the burden of proof. IC 6-8.1-5-1(b) states in pertinent part:

> The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

The Indiana Administrative Code also states "[t]he burden of proving that a proposed assessment is incorrect rests with the taxpayer. . .." 45 IAC 15-5-3(b).

The taxpayer protests miscellaneous items, which are listed as the following sub-issues: (1) Missing Invoices; (2) Direct Offsetting Entries; (3) Promotional Materials; (4) Cardboard Baler; (5) Computer Software for Manufacturing Equipment; (6) Anticon Gold Wipes; (7) Thermal Bar Code Labels; (8) Software Received by Download; and (9) License Fees/Software Maintenance.

(1) Missing Invoices:

The taxpayer notes in correspondence, "During the audit fieldwork, some of the 1,849 invoices identified in the Automotive expense sample were missing from our files and consequently, were identified as taxable in the sample." Taxpayer later "obtained copies of eight missing invoices directly from our vendors and one from our files." Taxpayer is sustained on this issue subject to verification by Audit.

(2) Direct Offsetting Entries

The taxpayer "protests the imposition of Use tax created by including *direct* offsetting entries in different stratums of the audit sample." Taxpayer does not cite to any statutes or regulations on this issue and has not met its burden of proof.

(3) Promotional Materials

The audit report states:

> The taxpayer purchased brochures and other printed material from Indiana printers where no sales tax was paid at the point of purchase. The taxpayer contends that the portion of these purchases of printed materials that were ultimately sent out of state should receive exemption under the temporary storage exemption.

IC 6-2.5-3-2 states in pertinent part (*Emphasis* added):

> (a) An excise tax, known as the use tax, is imposed on *the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction*, regardless of the location of that transaction or of the retail merchant making that transaction.
>
> . . .
>
> *(d) Notwithstanding any other provision of this section, the use tax is not imposed on the keeping, retaining, or exercising of any right or power over tangible personal property, if:*
>
> *(1) the property is delivered into Indiana by or for the purchaser of the property*;
>
> (2) the property is delivered in Indiana for the sole purpose of being processed, printed, fabricated, or manufactured into, attached to, or incorporated into other tangible personal property; and
>
> (3) the property is subsequently transported out of state for use solely outside Indiana.

The audit report focuses on the language in IC 6-2.5-3-2(d)(1), specifically "delivered into Indiana." The taxpayer focuses on IC 6-2.5-3-2(a), and also cites to case law.

Regarding IC 6-2.5-3-2(a), the taxpayer argues,

[F]or purchases to be subject to Use tax under section (a), the following requirements must be met:

1. The purchase must be of tangible personal property,
2. The tangible personal property must be stored, used, or consumed in Indiana, and
3. The property must be acquired in a retail transaction.

The taxpayer further states:

[Taxpayer] concedes (1) and (3) are met. However, the tangible personal property was not "stored, used or consumed in Indiana" as defined by the Law, and therefore is not subject to Use tax.

Taxpayer then cites to the definition of storage found at IC 6-2.5-3-1(b):

"Storage" means the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana.

"Use" is defined at IC 6-2.5-3-1(a):

"Use" means the exercise of any right or power of ownership over tangible personal property.

Taxpayer states, "The Indiana Tax Court has previously held that the storage exception limits and qualifies the meaning of 'use.'" The taxpayer then cites to *USAir, Inc. v. Indiana Department of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993). The Tax Court states in *USAir:*

When property is stored in Indiana solely for subsequent use outside Indiana, it is of course 'used' to satisfy some need, but it is not taxably used within the meaning of IC 6-2.5-3. By the same token, it is quite naturally impossible for property to go from "storage" in Indiana to "use" elsewhere without some incidental handling or transport, but once again there is no taxable use. To hold otherwise and follow the Department's reasoning would subsume "storage" within "use" and nullify the exception for use outside Indiana.

Id. at 470. Taxpayer concludes (regarding its situation) that "the printed material was not 'stored, used, or consumed in Indiana and thus are exempt. . .." (It should be noted that in *USAir* the Tax Court found, "USAir exercises ownership rights over the food in Indiana and is therefore subject to imposition of the use tax." *Id.* at 471. The taxpayer also briefly alludes to another tax court case, but does not develop that argument).

The Department notes that the "Application for Direct Pay Authorization" explicitly states (*Emphasis* added):

Direct pay authorization *may not* be used for . . . *property purchased in Indiana for storage in Indiana and subsequent use outside Indiana as provided by the exception contained in IC 6-2.5-3-1 and 2.*

The Department also notes that the Indiana Tax Court in *USAir* stated that "Indiana has complementary sales and use taxes." *USAir* at 468. Further the Tax Court said,

The complementary formulation exists to ensure non-exempt retail transactions that escape sales tax liability are nonetheless taxed.

Id. at 469.

To summarize: the taxpayer used a Direct Pay Permit in a manner not allowed (*See* the language from the Application cited above); IC 6-2.5-3-2(d)(1) states the property has to be "delivered into Indiana by or for the purchaser of the property." The property was not delivered "into Indiana." Furthermore, the burden of proving the assessment is wrong rests with the taxpayer, as provided in IC 6-8.1-5-1(b). Taxpayer has not met this burden.

(4) Cardboard Baler

A cardboard baler was assessed tax. Taxpayer argues that it is "used in the processing of tangible personal property which is sold in a subsequent retail transaction." The taxpayer describes the cardboard baler thusly: "The CardBoard Baler is used to process empty cardboard boxes into baled and tied units, which are then sold to a recycle processor." Taxpayer then cites to IC 6-2.5-5-3(b) (*Emphasis* added):

(b) Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, *processing*, refining, or finishing of other tangible personal property.

The Department cites to 45 IAC 2.2-5-10(k) which defines "processing or refining" as "the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired." Further, "The change in form, composition, or character must be a substantial change."

The audit report states, regarding the baler, "There is no processing involved . . . as there is no change in the taxpayer's marketable product." The baler is simply "used to apply banding to the empty cardboard boxes and facilitate their shipping." The taxpayer's protest on this issue is denied.

(5) Computer Software for Manufacturing Equipment

At issue here is "Use tax on network security software and antivirus software installed on computers used in manufacturing." The taxpayer cites to IC 6-2.5-5-3(b). The taxpayer argues that the security software and antivirus software are "used to operate exempt manufacturing equipment. . .."

The security software and antivirus software does not meet the so-called "double direct" test of IC 6-2.5-5-3(b)–"direct use in the direct production. . .." Also, 45 IAC 2.2-5-8(j) notes that "tangible personal property" used in "safety or fire prevention which does not have an immediate effect on the product" is taxable. The software at issue is analogous to tangible personal property used for "safety" purposes (in this instance, to "protect the manufacturing computers") and is taxable.

(6) Anticon Gold Wipes

The audit report states:

The taxpayer purchased Anticon gold wipes where no sales tax was paid at the point of purchase. These wipes are used to collect waste precious metals that are left over from the taxpayer's manufacturing process.

Two facilities are at issue, which we will refer to as Location B and Location L. The audit report states:

In the case of the taxpayer's [Location B] facility these wipes are then incinerated and the ash is sent to a recycler who reclaims the precious metals from the ash. The taxpayer is then given a check for the precious metals less refining, treatment, and transportation charges by the third party recycler. At the taxpayer's [Location L] facility the wipes are not incinerated by the taxpayer but are sent directly to the recycler who does the incinerating of the wipes before reclaiming the precious metals.

Taxpayer argues:

At [Location B], the wipes are used to collect gold residue. In the final step of production, the wipes are consumed (by incineration) and the final product (gold residue), is sold to customers. Again, [taxpayer] contends that the gold residue is the result of a secondary process that begins with the production of electronic components and sub-assemblies. This secondary production process results in a product for resale (i.e. gold residue) and in the process, the Anticon wipes are consumed as part of the production process.

Regarding the production process argument, the taxpayer produces electronic components–not residue. The residue is a leftover from the taxpayer's actual production process.

The taxpayer also argues that "the wipes are exempt as nonreturnable containers." Taxpayer states it "purchases the wipes as nonreturnable containers, adds gold residue as the contents and sells the gold residue to the recycler."

The wipes are not packaging and they are not a nonreturnable container. 45 IAC 2.2-5-16(a) states in part:

The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added. . ..

That a wipe is not a container is shown by the fact that a wipe is either clean or with residue; it is not "empty." Nor has the taxpayer shown that a wipe is sold, marketed, etc. as a form of wrapping material or as a container. The gold residue is not "added" to the wipes. The wipes pick up the gold residue, in a process akin to a dust cloth wiping up dust. Taxpayer's protest is denied.

(7) Thermal Bar Code Labels

Two sizes of bar code labels are at issue (small and large). The taxpayer describes the small thermal bar code labels thusly:

During the production process, the electronic components are placed on a tape that is rolled onto a reel. As required by the customer, a thermal bar code label is placed on the reel. The reel is packaged and sold to the customer.

The Department agrees that the small thermal bar code labels are exempt as material incorporated into tangible personal property (*See*45 IAC 2.2-5-14).

The large thermal bar code label "is placed on the boxed product being shipped to the customer." The shipping box is not the taxpayer's product, thus the large labels are not incorporated as required by 45 IAC 2.2-5-14.

The taxpayer prevails regarding the small thermal bar code labels, and loses with regards to the large ones.

(8) Software Received by Download

Taxpayer argues "Indiana Law was amended effective January 1, 2004 (IC 6-2.5-1-27) to redefine 'tangible personal property' to include 'prewritten computer software.'" The taxpayer then notes, "The audit period was prior to the change in definition to tangible personal property."

Actually there was not a change in definition. In 1990 the Department noted in an Information Bulletin that "pre-written programs" were subject to tax (*See* Information Bulletin #8, February 1990). The statute cited by the taxpayer merely clarified this for Streamlined Sales Tax purposes. The taxpayer's protest is denied.

(9) License Fees/Software Maintenance

Taxpayer "protests the imposition of Use tax on software license fees. Two invoices representing fees for the intangible rights to use computer software do not include any tangible personal property and therefore, are not retail transactions subject to gross retail tax." Again, the taxpayer states:

As strictly a license fee, this invoice is not for tangible personal property and therefore, is not a retail transaction subject to tax pursuant to IC 6-2.5-4-1.

The taxpayer offers conclusions, but the taxpayer does not develop the argument necessary to buttress its conclusions. The taxpayer also did not provide with its protest correspondence a copy of the licensing agreement. As noted at the outset, the taxpayer bears the burden of proof and has not met it regarding this issue.

Next, the taxpayer makes an argument about a software maintenance agreement:

Although the agreement states that the fee for the maintenance agreement includes any upgrades that become available, it does not guarantee that upgrades will be provided. In fact, [taxpayer] has not received any upgrades to the Hyperion software to date. Since there is no guarantee that property will be supplied

during the warranty period, the warranties are not subject to sales and use tax.

Taxpayer then cites to Information Bulletin #2. The relevant language from Information Bulletin #2, November 2000, states:

Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.

Further, an example is provided which states in relevant part:

4. A computer software company sells a taxable software package to a customer. The customer also purchases an optional maintenance agreement from the company. . .. The maintenance agreement also entitles the customer to periodic software updates. The computer software company calculates that the price charged for the software updates is 5 [percent] compared with the service charge. The software maintenance agreement is not subject to sales tax.

Information Bulletin #2 also notes (*Emphasis* added): "If the provisions contained in the warranties or agreements are not in *complete* compliance with all provisions of Rule 45 IAC 2.2-4-2, this will constitute a transaction of a retail merchant selling at retail. Thus, the service provider must collect sales tax on the unitary price pursuant to IC 6-2.5-2-1." Taxpayer has not shown that the maintenance agreement was in *complete* compliance with 45 IAC 2.2-4-2 (no copy of the maintenance agreement was provided in the taxpayer's protest correspondence), and thus has not met its burden of proof.

FINDING

Taxpayer's protest of all the sub-issues is denied, except for the following: for sub-issue (1) Missing Invoices, the taxpayer is sustained subject to verification by Audit; the taxpayer is also sustained with regards to the small thermal bar code labels addressed in sub-issue (7).

II. Tax Administration–Negligence Penalty and Interest

DISCUSSION

Taxpayer protests the imposition of penalty and interest. With regard to interest, the Department refers to IC 6-8.1-10-1, which states in relevant part (*Emphasis* added):

(a) If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on his return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

. . .

(e) The department *may not waive* the interest imposed under this section.

With regard to the penalty, the Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c)(1) provides:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

Taxpayer states that it "has consistently made every effort to comply with the various sales and use tax laws and regulations of Indiana." Further, the taxpayer states:

Although an additional assessment resulted from the audit, [taxpayer] has made every effort to correctly interpret Indiana's sales and use tax laws and regulations in determining the taxability of our purchases . . ..

Given the complexity and the "nature of the tax[es] involved," the Department agrees that the taxpayer has established "reasonable cause."

FINDING

Taxpayer's protest is sustained.

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